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Sokol's decisions raise ethical, legal issues for Berkshire Hathaway

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Berkshire Hathaway Inc. is likely to face intense scrutiny from the investment community and possibly the SEC, industry observers said, following revelations about departed executive David Sokol's personal trading activity.

The chairman of three Berkshire subsidiaries and possible successor to Chairman and CEO Warren Buffett abruptly resigned March 28, citing a desire to focus on investing his own money. It is the decisions he recently made with that personal money, however, that have thrown a spotlight on the storied investment firm.

In a March 30 statement announcing the departure, Buffett disclosed that Sokol purchased about $10 million in shares of Lubrizol Corp. prior to suggesting that Berkshire consider acquiring the specialty chemicals company. Sokol later held a meeting with Lubrizol CEO James Hambrick, leading to enough interest from Buffett to pursue a transaction.

He netted approximately $3 million from his stake in Lubrizol when Berkshire agreed to purchase the company for about $9 billion in mid-March.

Both Berkshire and Sokol maintain that there was nothing illegal about Sokol owning stock in a company he later pitched as a takeover target. Buffett in the statement said Sokol had "no voice" in the decision to buy Lubrizol, while Sokol said he did not believe Buffett would be interested in such a deal.

"Nineteen out of 20 times when we even have a conversation with someone, it doesn't go any further," he said in a March 31 interview on CNBC. "This one happened to go faster once Warren got involved with it, but that was outside of my control."

Nevertheless, the SEC reportedly is weighing an investigation into Sokol's conduct, and securities lawyers say his investments fall into a legal gray area.

"Insider trading is a very factually specific inquiry," said Richard Roth, president of The Roth Law Firm in New York. "If in fact Sokol just knew of Lubrizol as a good company and he liked it ... then it's on one end of the spectrum. The other end of the spectrum is if he knew about the company, knew they were a target ... and was going to recommend it to Buffett and believed Buffett would say yes."

He told SNL the answer is likely somewhere in the middle, but that the short time between Sokol's purchases and the acquisition make the situation appear suspicious.

According to accounts from Sokol, Buffett and Lubrizol's March 25 proxy filing with the SEC, Citigroup Inc. investment bankers on Dec. 13, 2010, presented Sokol with an 18-company list of possible acquisition targets for Berkshire. Of those companies, Sokol said he was interested only in Lubrizol, and asked the bankers to set up a meeting with Hambrick to discuss the two companies.

The following day, Sokol personally purchased 2,300 shares of Lubrizol. He sold that stake one week later, telling CNBC he could not purchase enough shares to make the investment worthwhile.

However, between Jan. 5 and Jan. 7, he made another investment, this time purchasing 96,060 shares equaling roughly $100 million. Only after, Buffett said, did Sokol approach him about Lubrizol as an acquisition possibility, at which time Sokol said he also disclosed his investment.

At dinner on Jan. 25, Sokol and Hambrick discussed Lubrizol, but did not get into the specifics of a possible transaction. After reporting back to Buffett, Sokol said he was no longer involved in the matter.

"The reality is, I have no control over a deal ever happening," he said on CNBC. "I don't believe I did anything wrong."

Roth said Sokol does not appear to have done anything explicitly illegal, but said it is still possible his actions could be deemed insider trading.

"It really comes down to one thing, and the question is whether he knew or had reason to believe that Buffett and/or Berkshire was going to pitch Lubrizol when he bought [the shares]," he said. "I assure you that Berkshire, and probably the SEC, is going to do more inquiry into this. They're going to look at phone records, they're going to look at how often he spoke to the Lubrizol people."

Meyers & Heim Partner Robert Heim, who spent six years with the SEC, said the agency probably will look into whether Sokol received "material, nonpublic" information during his meetings with Citigroup and Lubrizol.

"I think it's a very close case," he told SNL. "The problem Mr. Sokol may have is that he learned about Lubrizol in his capacity as an officer at Berkshire Hathaway."

The SEC declined to comment on whether it was looking into Sokol's actions. Yet even if the SEC decided not to get involved, Stifel Nicolaus analyst Meyer Shields told SNL, Berkshire will have to answer a number of questions about its internal conduct.

"This is a company, this is a stock that trades so much on its perception of being different and better than most companies," he said. "This activity doesn't seem to be better than most companies."

Left unanswered is why neither Buffett nor CFO Marc Hamburg — whom Sokol said he told about the shares in mid-March — did not tell Sokol to sell the stake once negotiations became serious, or whether it is a widespread practice for employees to hold similar investments. Sokol said on CNBC that Vice Chairman Charles Munger had a 3% stake in Chinese auto and battery-maker BYD Co. Ltd. when he suggested that MidAmerican Energy Holdings Co. take a look into it. Berkshire's internal ethics code says that any potentially conflicting investment must gain approval from the audit committee, a process Sokol did not undergo.

Also unknown is whether the timing of Sokol's resignation was connected to his Lubrizol stake. The holding would have gone public in Berkshire's upcoming proxy statement.

Berkshire's Hamburg did not return multiple phone calls for this report.

"The fact that Warren Buffett readily accepted his resignation, in contrast to last time, suggested that even if the resignation was not done in response to the stock trading, the acceptance of that resignation was," Shields said, noting that Buffett two years ago persuaded Sokol not to resign.

Perhaps most vexing for Berkshire shareholders, though, is how Sokol's departure impacts the firm's succession plan. Sokol was thought to be among four candidates to take over when Buffett leaves the company, but Sokol told CNBC he was never in the running.

"I was very much in the camp thinking that David Sokol was being groomed to take over," Shields said. "It was widely assumed and it was incorrect because on the ... outside as analysts and investors, we just don't know what management was thinking."

The remaining candidates are believed to include executives Ajit Jain, Greg Abel and Burlington Northern Santa Fe LLC head Matthew Rose.

No matter the true circumstances surrounding Sokol's sudden departure, it has planted Berkshire firmly under a microscope and, at least temporarily, tarnished an image the company has worked hard to preserve.

"I think that it definitely looks suspicious," Roth said. "It's just a black eye for Buffett, because Buffett prides himself on high character, integrity and essentially being a squeaky clean person." *i*